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China: Foreign Trade Resurgence

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A Research Paper

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A Research Paper

This paper was prepared by [redacted] Office of East Asian Analysis. Comments and queries are welcome and may be directed to the Chief, China Division, OEA, [redacted] 25X1 25X1

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China: Foreign Trade Resurgence

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Summary

Information available as of 1 October 1984 was used in this report.

Earlier this year Beijing renewed its commitment to the open-door policy and economic reform. These decisions will greatly benefit foreign trade, as well as the domestic economy. Over the past 35 years centralized planning and an arbitrary pricing system have hampered China's integration into the world economy. The loosening of central controls and the adoption of price reforms at the October meeting of the party's 12th Central Committee will help China realize greater gains from international trade by providing economically more rational criteria for trade and investment decisions. Conversely, increased competition through international trade will give the Chinese a barometer to assess the performance of the domestic economy. 25X1

This paper briefly describes the economic events that led to Beijing's decision to reassert an open-trade policy and examines current trends in China's international economic affairs. It also assesses the impact of the economic readjustment and reforms on China's international finances and forecasts China's balance of payments in 1984. 25X1

Late last year China began to resume its capital-import program after a three-year hiatus, and this year foreign purchases have picked up sharply. Although Beijing all but halted new orders for Western equipment and technology during its attempt to readjust the domestic economy, it continued to lay the groundwork for close trading relations with the West. It enacted legislation on foreign investments and patents, signed bilateral tax and investment treaties with several countries, and joined the Multi-Fiber Arrangement under the General Agreement on Tariffs and Trade and the International Atomic Energy Agency. 25X1

Export expansion and import restraint have given the Chinese three consecutive years of substantial trade and current account surpluses. China's total international reserve holdings rose to nearly $20 billion by the end of 1983, the 10th largest in the world. Although this achievement improved China's already excellent international credit rating, China would have derived even greater economic benefits from investing these funds at home. 25X1

In 1983 China began to put its foreign exchange earnings to more productive use. It allocated funds not only for domestic infrastructural projects such as energy, transportation, and communications, where lack of investment had severely constrained economic growth, but also for light industry and agriculture. These investments have boosted the opportunities for foreign sales to and cooperative ventures with China. 25X1

EA 84-10209
December 1984

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All signs point to a resurgence of trade this year. We expect imports to grow 25 to 30 percent. The largest gains—at least 50 to 70 percent—will be in capital goods. Transport equipment purchases in particular have surged, boding well for the United States in such areas as jet aircraft, helicopters, and locomotives. Agricultural imports, however, will continue to decline, reflecting four consecutive years of excellent harvests. [redacted] 25X1

Although exports jumped 22 percent in the first half of 1984 compared with the first half of 1983, we do not expect this trend to continue. For the year as a whole, exports probably will rise only 15 to 20 percent. Beijing itself is concerned about developments at home and abroad that will affect long-term prospects for China's exports. Externally, protectionism has reduced the developed countries' demand for China's exports. Internally, budget deficits—partly caused by mounting subsidies to foreign trade—have occupied the attention of Chinese leaders. [redacted] 25X1

To compensate for volume quotas and other quantitative restrictions on their exports, the Chinese have had to export higher quality goods—products that compete more directly with items produced in the West. Beijing also has tried to open up new markets in the Middle East, the Soviet Union, South Korea, and Latin America. These markets have grown quickly but will not provide a solution for China's vast, long-term foreign exchange needs. [redacted] 25X1

Over the past two years domestic financial losses from foreign trade have ballooned. Because domestic prices are not in line with world prices, Beijing has had to subsidize both exports and imports of some products to achieve the desired product mix. Furthermore, as the foreign trade system became more decentralized, China's irrational domestic price structure tended to distort the desired commodity trade patterns. [redacted] 25X1

In March the Ministry of Foreign Economic Relations and Trade announced that trade would be recentralized under its aegis, ostensibly to solve these problems. There are serious disagreements in Beijing over the needed solutions, however, with many in power favoring price reforms instead of recentralization. We believe that even if recentralization were carried out—which now appears unlikely—it would not curtail trade at the local and provincial level, nor ease the need for subsidies. [redacted] 25X1

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Beijing's slow progress in attracting foreign investment had been caused in part by disagreements between Chinese leaders on the extent of incentives that should be offered to foreign companies. This past year, however, Beijing pushed forward with its open-door policy by opening additional port cities to foreign investment and giving them greater decisionmaking authority. Foreign investment in China, which at the end of 1983 totaled $1.5 billion, including that in offshore oil, probably will climb to over $2.5 billion by the end of this year. 25X1

China's change in status from net debtor to creditor stems both from Beijing's readjustment policy and from stringent foreign exchange control measures established in early 1981:

- The Chinese have used very little of the $27 billion in commercial and government-supported credit lines they arranged in 1979.
- Last year China prepaid most of its long-term commercial debt as well as all of its first credit tranche from the International Monetary Fund.
- Beijing is restructuring the small foreign debt that remains by reducing interbank borrowings and taking on long-term, low-interest loans from the World Bank, Japan's Overseas Economic Cooperation Fund, and other official sources.

Nevertheless, over the longer term, China will need to tap the commercial markets in a big way if it is to complete its ambitious development plans.

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Contents

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China: Foreign Trade Resurgence

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The three-year hiatus in China's capital-import program that began in early 1981 has ended, and China is again seeking Western equipment and technology. Beijing has reordered its priorities and has begun to erect an institutional framework to attract foreign investment. It is now intensifying the search for foreign partners.

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Impact of the Economic Readjustment

Under the economic readjustment program announced in 1979, the Chinese cut investment in order to stimulate consumption. At the same time, they deemphasized heavy industry in favor of light industry. As a result, imports of producer goods and industrial supplies plummeted. Contrary to speculation in the Western press, the dropoff in purchases did not reflect foreign exchange difficulties. Chinese exports were growing rapidly, and Beijing had access to large sums of credit in the West.

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The resulting trade surpluses boosted China's international reserves to nearly $20 billion by the end of 1983, the 10th largest total reserves in the world and the seventh largest in terms of foreign exchange alone (see table 1). This level of reserves—more than one year's worth of imports—was much larger than needed to cover any exigencies.

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For a capital-poor country the change from capital importer to capital exporter made little economic sense. Interest earnings on China's deposits in foreign banks were far less than the potential return on capital invested domestically. Foreign exchange deposits abroad did nothing to rebuild China's aging infrastructure nor to upgrade its inefficient industrial base. Moreover, maintaining a trade surplus created inflationary pressures at home—state procurement of goods for export injected more currency into circulation than was absorbed by domestic sales of imports, that is, more money chased fewer goods. The large buildup of foreign exchange reserves also raised the question of whether China deserved access to low-cost funds from the World Bank and other international lending agencies.

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Table 1
Worldwide Holdings of International Reserves, Yearend 1983

Billion US $

Country [a]	Total Reserves	Gold [b]	Foreign Exchange	SDRs [c]
United States	124.9	102.3	6.3	16.3
West Germany	79.7	37.0	37.3	5.4
France	51.6	31.8	18.1	1.7
Switzerland	46.7	32.3	14.4	0
Italy	46.0	25.9	18.5	1.6
USSR	39.3	29.8	9.5	0
Japan	34.0	9.4	20.4	4.2
Saudi Arabia	29.2	1.9	17.5	9.8
Netherlands	27.3	17.1	8.7	1.5
China	19.8	4.9	14.3	0.5
United Kingdom	18.2	7.4	8.7	2.1
Belgium	18.0	13.3	3.8	0.9
Spain	13.1	5.7	7.0	0.4
Taiwan	12.8	1.4	11.4	0
Austria	12.7	8.2	3.9	0.6
Venezuela	12.1	4.5	6.3	1.3
Australia	12.0	3.1	8.7	0.2
Singapore	9.2	0	9.1	0.1
India	8.2	3.3	4.3	0.6
Norway	7.1	0.5	5.9	0.7

[a] In order by relative size of holdings.
[b] Valued at the yearend market rate.
[c] For purposes of this table, the column on holdings of SDRs (Special Drawing Rights) includes the country's reserve position in the IMF.

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In 1983 China began to put its foreign exchange earnings to more productive use. It invested them not only in domestic infrastructural projects such as energy, transportation, and communications, where lack of investment had severely constrained economic

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growth, but also in light industry and agriculture. By the fourth quarter of 1983, China's imports of capital equipment approached the record level of 1980, yet one of the biggest categories of capital goods—payments for industrial know-how, production licenses, technical services, and various forms of consultancy—does not show up in the trade returns. We estimate that payments for such invisibles exceeded $1 billion last year.

Although imports slumped during 1981-83, Beijing continued to lay the foundation for even closer trading relations with the West. It joined both the Multi-Fiber Arrangement under the auspices of the General Agreement on Tariffs and Trade (GATT) and the International Atomic Energy Agency (IAEA). It enacted a joint-venture law and completed work on a patent law to make investing in China more attractive to foreign entrepreneurs. It also signed bilateral tax and investment treaties with Japan and other countries, establishing the rights of foreign investors. And it established sizable lines-of-credit with Japan, the World Bank, and Western commercial banks, which will allow China to proceed rapidly with major infrastructure projects once technical negotiations are concluded.

More than any other move, however, Beijing's decision in April 1984 to open 14 additional port cities and Hainan Island to foreign investment reflects its commitment to the open-door policy. As a result of the decision, local authorities in these areas will be given greater freedom to accept foreign investments without Beijing's approval, similar in many respects to the powers granted the authorities in the Special Economic Zones. Foreign investors in the new "economic development zones" will be given preferential tax rates, a waiver of import duties on goods that will be reexported, and greater access to domestic markets.

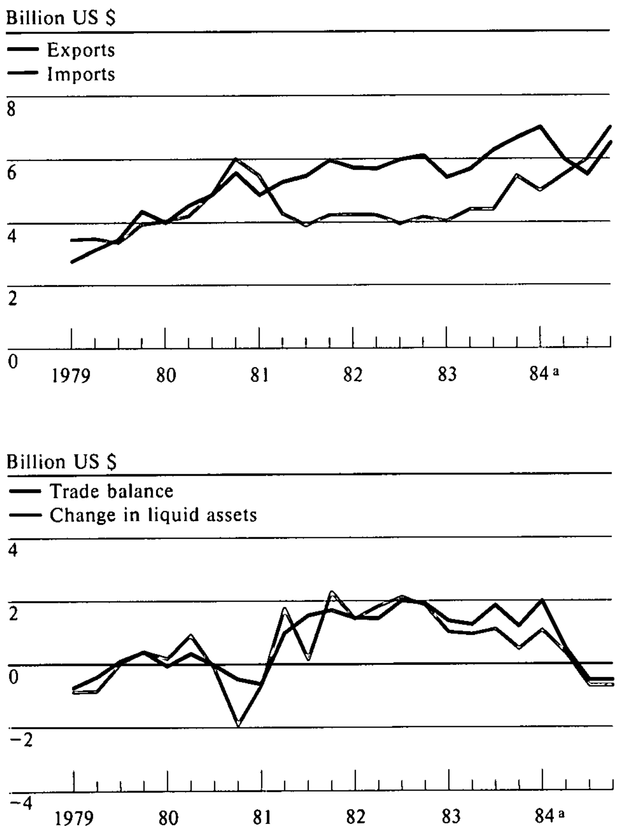
This decision is a major departure from the past. Under Deng Xiaoping, Beijing has now assigned a leading role to the port cities in China's modernization process, contradicting Mao's longstanding policy of balanced growth between the coast and interior. In large part we believe the new policy is a pragmatic attempt to deal with an economic reality—China's transportation system is so overburdened that in real terms it often costs more for the port cities to trade with inland areas than with foreign countries. 25X1

The decision, however, also reflects the growing influence localities have on policies emanating from Beijing. Local and provincial authorities have warmly embraced their new prerogatives—indeed, many inland cities are now claiming to possess the same rights as those granted to the coastal cities. 25X1 The ability of localities to attract foreign funds for their investment projects gives them an alternative to using central government funds and a means of circumventing Beijing's controls. Under the financial "responsibility" system now being instituted, the ability to find new sources of funds may be critical to economic survival. 25X1

These actions will begin to bear fruit this year, significantly boosting the opportunities for foreign sales to and cooperative ventures with China. All signs point to a resurgence of trade. China's imports already have started to take off—they are more than 20 percent higher than at the same time last year. Imports of capital goods and industrial supplies—particularly steel, nonferrous metals, lumber, and plastics—lead the list; imports of agricultural commodities have dropped following three consecutive years of excellent harvests. 25X1 For the year as a whole we expect imports will climb 25 to 30 percent to $23-24 billion. 25X1

Exports have jumped even more—22 percent in the first half of 1984—to produce the highest first-half trade surplus ever, but we do not expect this trend to continue. The Foreign Trade Ministry's announcement in mid-March that trade would be recentralized may have caused a temporary surge that could lead to a subsequent slowdown. We believe export growth for the year will be limited to about 15 to 20 percent, reducing the trade surplus to $3-5 billion. 25X1 Most of this surplus will have occurred in the first half. In the second half, China's trade balance will decline considerably (see figure 1). 25X1

Figure 1
China's Trade and Net Foreign Assets, 1979-84



a Projected.

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Whether China's reserves will continue to grow will depend in part on complex equity and debt considerations. Based on past patterns, we would expect reserves to follow the trend of the trade balance. Although Beijing wants to reduce the level of its reserves, much of the capital equipment China will get will be through direct foreign investment or on buyer's credits. Therefore, reserves might not decline and could even increase. We project that by yearend reserves will be $2-4 billion higher than at the end of 1983.

The Uncertainties Ahead

This past May, in his report to the National People's Congress on the 1984 economic plan, Song Ping, Minister in Charge of the State Planning Commission, announced that China's total trade volume in 1984 would decline 5 percent from the 1983 level. Wang Weicai, director of the State General Administration of Foreign Exchange Control, has stated that China will run a merchandise trade deficit for the year. We believe the Chinese projections seriously underestimate trade growth in 1984, particularly for exports. In the last three years Chinese officials have consistently made inaccurate predictions of China's foreign trade prospects. Lack of up-to-date trade data and the volatility of the international economy are largely to blame. Growing uncertainty over the prospects for exports, caused by both external and internal developments, has added to Beijing's cautiousness this year. 25X1

Recession and Protectionism. Externally, recession and protectionism have reduced developed-country demand for China's exports. Over the past two years lower world market commodity prices have hurt China's agricultural, mineral, and crude oil exports. At the same time, Chinese attempts to gain greater access to the US and EC textile markets have been rebuffed. 25X1

In response China has attempted to boost sales to the Soviet Union, the Middle East, South Korea, and other untapped markets. Arms sales to the Middle East, for example, shot up from almost nothing in 1980 to an estimated $1.5 billion last year—6 percent of total exports. In an attempt to earn foreign exchange, China has even offered to store nuclear waste materials for several West European nations. Beijing hopes that increased trade with the Soviets may also help reduce Sino-Soviet tensions and that increased trade with the less developed countries will increase China's visibility, foster better political relations, and diminish Soviet influence. All of these markets, however, involve some long-term political risks and will provide only a short-term boost to China's hard currency earnings. 25X1

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Budgetary Problems. Internally, budgetary problems continue to occupy the attention of Chinese leaders. The central budget remained in deficit in 1983, particularly because subsidies to agriculture and foreign trade took an unanticipated jump. [redacted] Efforts to trim these subsidies could restrict the growth of both exports and imports this year [redacted]

The trade subsidies are a result of China's irrational price structure—domestic prices are fixed arbitrarily and are not in line with world market prices. At the "internal settlement rate" of 2.8 yuan per dollar—the exchange rate at which Chinese entities are permitted to convert foreign exchange into yuan at the Bank of China—the domestic prices of primary products generally appear to be lower than world prices and those of manufactures appear to be higher.[1] Hence, it is generally profitable for Chinese traders to export primary products and to import manufactures. The reverse—exporting manufactures and importing primary products—tends to produce losses. [redacted]

At the official exchange rate in use prior to 1981, exports produced losses, on balance, while imports produced profits, a sure sign of the overvaluation of a currency.[2] Because foreign trade corporations (FTCs) under the Ministry of Foreign Trade handled all trade, the FTCs could offset the losses on trade in one commodity with the gains made on another, and such losses or gains did not affect the decision to trade. [redacted]

As China's foreign trade system became more decentralized, however, the domestic price structure led to a trade pattern that was contrary to China's comparative advantage. The price system encouraged exports of capital- and land-intensive commodities that were in short supply (for example, oil, steel, and tobacco) and encouraged imports of labor-intensive manufactures that could have been produced for a lower real cost at home (for example, cameras, televisions, radios, and wristwatches). [redacted]

[1] It is difficult to generalize about Chinese prices. The generalization above applies only to major commodities at the wholesale level that would enter into world trade; it does not apply to retail prices. [redacted]

[2] During most of the 1970s, the official exchange rate, as published by the Bank of China, floated between 1.5 and 2.0 yuan per dollar. [redacted]

Since early 1981 Beijing has taken several steps to counteract these distortions. First, Beijing—in effect—devalued the yuan by introducing the internal settlement rate. Although this step reduced the level of subsidies for exports, it increased subsidies for many imports. Moreover, with a decline in some highly profitable imports that resulted from the readjustment of the economy and with a decline in world prices for many of China's exports, net financial losses from trade increased sharply, resulting in record government subsidies last year. [redacted]

In 1982 Beijing introduced a trade licensing system and revised its tariff system to prevent local enterprises from exporting goods in short supply or from importing goods that competed with domestic products. The licensing system gave the Ministry of Foreign Economic Relations and Trade (MFERT) new regulatory and oversight capabilities, while the new tariffs—on exports as well as imports—helped to shield the domestic price structure from the effects of international trade.[3] [redacted]

Finally, in March of this year MFERT announced that trade would be recentralized under its aegis. Pricing and supply problems created by the decentralization were offered as reasons for reasserting MFERT control. While these problems are no doubt real, we believe the recentralization announcement also was part of an attempt by Chen Muhua and others in MFERT to boost their positions within China's economic bureaucracy. [redacted]

Even if the recentralization order were carried out, we doubt that it would have significant consequences for the trade of local and provincial enterprises. Its primary effect would be to shuffle lines of responsibility for trade within the central government itself. Last year the FTCs under MFERT reportedly were directly responsible for about 40 percent of China's foreign trade, other ministries of the central government conducted about 20 percent, and local and provincial

[3] Export tariffs prevented Chinese traders from price cutting and thereby passing windfall profits on to foreign buyers, and import tariffs raised the domestic prices of foreign goods to protect local industries. [redacted]

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enterprises were responsible for the rest. Under the recentralization order, MFERT was slated to recoup most of the trade conducted previously by other ministries.[4] The lengthy treatment given in the Chinese press to the recentralization announcement suggests that Beijing merely intended to make the operations of MFERT an example of how administration and economic management can be separated. Thus, many of the local producers, end users, and trading firms would continue to make economic decisions, while MFERT would administer the plan, regulating provincial trade through the use of licenses, tariffs, and other indirect controls. Although MFERT would exercise greater oversight, it would not supplant provincial corporations.

In anticipation of the recentralization announcement, many trade organizations in China may have rushed to fill standing export contracts in advance—one possible explanation for the strong upturn in exports in the first quarter. According to business reports on the spring Canton trade fair, prices were up 10 to 15 percent, perhaps an indication of MFERT's new effectiveness in coordinating foreign trade negotiations. Whatever the reasons for the recent surge in Chinese exports, if Beijing maintains a disproportionate incentive to export and continues tight controls on imports, China's current account surpluses are unlikely to evaporate.

Balance of Payments: Flush With Reserves

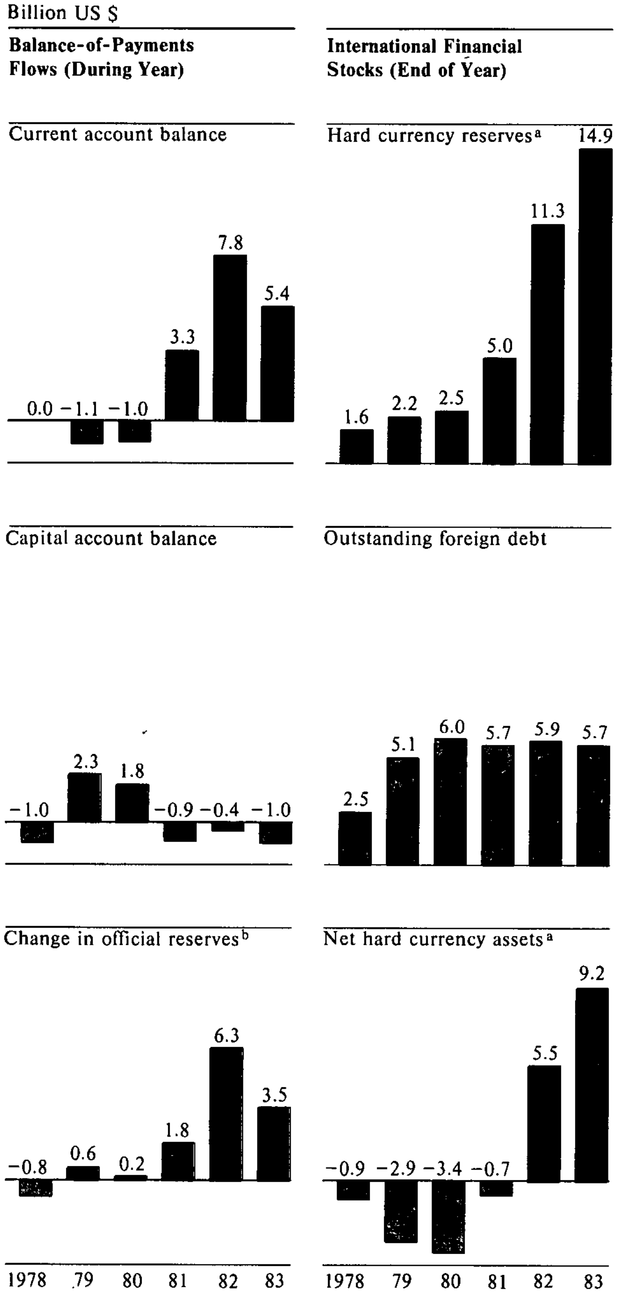
China's central planners have attempted to prevent domestic economic pressures from causing excess demand for foreign goods. Nevertheless, domestic economic developments are transmitted, at least partially, to the foreign sector after some lag. Hence, China's balance of payments has reflected Beijing's shifting national economic policies. Current account surpluses during 1976-78 gave way to deficits in 1979 and 1980, as deliveries began on the $10 billion worth of complete plants and equipment China had ordered in 1978. Readjustment policies favoring light industry and agriculture—announced in early 1979—did not affect China's current account until 1981, when deliveries of capital equipment and industrial supplies began to subside. Although the domestic economic recovery has been under way since 1982, imports began to pick up only in late 1983. Continuing export expansion and restraints on imports have given the Chinese three consecutive years of substantial trade and current account surpluses (see figure 2). 25X1

Although the growth rate of trade in services has outpaced that in merchandise, service expenditures have generally exceeded earnings. Last year payments for industrial know-how, production licenses, technical services, and various forms of consultancy increased dramatically—we estimate that payments for such invisibles totaled about $1.2 billion. The Chinese are making a major effort to turn the deficit in 25X1 services into a surplus by expanding their international merchant fleet, improving tourist facilities, and boosting foreign sales of construction labor services. China now has 29,000 workers abroad, double the number in 1980, and plans to have 100,000 workers in LDCs by 1990. In addition, interest earnings on China's foreign exchange holdings have climbed sharply (see appendix). 25X1

In recent years China's net receipts from unrequited transfers have declined, primarily as a result of a slowdown in remittances from overseas Chinese. A decline in monetary remittances from Hong Kong probably reflects the opening up of the Crown Colony's 25X1 border with China—relatives now bring gifts instead of sending money—and the declining value of the Hong Kong dollar. Between 1980 and 1983 China received $71 million in funds from the UN, including $23 million from the UN Development Program, $8 million from the Fund for Population Activities, $25 million from the World Food Program, $5 million from the High Commissioner for Refugees, and $8 million from UNICEF (the UN Children's Fund). Since 1977 China has substantially cut back its aid to the Third World to conserve resources for its own economic development. Nevertheless, its aid abroad still exceeds the amount it gets from international organizations. 25X1

[4] The Ministries of Coal and Machine Building, the Chinese State Shipbuilding Corporation, and the China National Automotive Corporation are the only organizations known to have received a waiver to continue trading. 25X1

Figure 2
China's International Finances, 1978-83



[a] Excludes gold holdings, payments agreements assets, and "soft" loan assets.

[b] Excludes international gold transactions.

[redacted]

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Proceeds from the current account surpluses have been used to lift foreign exchange reserves to record levels, to reduce foreign commercial debt, and to increase investments abroad. China's international reserves, excluding gold,[5] totaled $14.9 billion at the end of 1983 and in mid-1984 amounted to more than $16.8 billion, while China's total foreign debt stood at only $5.7 billion. For the past three years Beijing has restructured its foreign debt by reducing interbank borrowings and taking on long-term low-interest loans from the World Bank, Japan's Overseas Economic Cooperation Fund (OECF), and other official sources. Last year China prepaid its first credit tranche by drawing from the International Monetary Fund (IMF) one year ahead of schedule; it also paid off almost $1 billion in commercial debt. In 1984, debt servicing probably will amount to less than 5 percent of China's export earnings. Last year foreign investment in China almost quadrupled the level of 1980, the first year any significant amount came in. This increase was not enough, however, to offset the heavy outflow of Chinese investment funds, particularly to Hong Kong and the United States. [redacted] 25X1

China's change in status from net debtor to creditor stems both from its readjustment policy and from stringent foreign exchange control measures established in early 1981. The decline in imports of capital goods mainly reflects reductions in investment in heavy industry. State budget deficits have reinforced the cutbacks in capital imports: in some cases domestic funds have not been sufficient to pay for the local costs of imported plants. [redacted] 25X1

Central regulations controlling foreign exchange have added to the growing reserves. Beginning in March 1981 Beijing required all domestic enterprises to deposit their foreign earnings with the Bank of China rather than in foreign banks. It further required enterprises to repay hard currency loans in hard currency. Imports by Chinese firms are thus limited largely by the value of their own exports; surplus foreign exchange can be sold to other enterprises, but

[5] Declared gold reserves amount to 12.7 million ounces, worth $4.9 billion at yearend 1983 market prices. [redacted] 25X1

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in the absence of developed capital or foreign exchange markets the regulations help assure a trade surplus. Although the Chinese began to relax their capital controls in 1983, particularly on the remittances of foreign partners in joint ventures, they still have far to go.

China is managing its foreign exchange reserves better than it did just a few years ago, keeping most in the form of interest-bearing short-term time deposits at banks in New York, Tokyo, Hong Kong, London, Paris, and Bern. For the past year the Chinese have not taken a strong position in the gold market, preferring instead to engage primarily in gold arbitrage. They have, however, purchased some silver on the international market for sales in China, apparently to soak up excess domestic currency. Chinese economists are aware of the irrationality of holding such a large amount of reserves and have recommended bringing them down to a level commensurate with the level of current account expenditures.

The Search for New Export Markets

In 1983, for the second consecutive year, recession and protectionism in the developed West slowed the growth of China's exports. Exports totaled $24 billion, up only 2 percent from the year before. This is far below the 25- to 30-percent annual growth rates achieved from 1978 to 1981.

We estimate that in 1984 China's exports will grow at a rate of 15 to 20 percent as recovery in the industrialized countries gathers momentum. Agricultural exports will be mixed, caught between higher world prices and increased domestic demand. Although the long-term outlook for exports from the extractive sector—including minerals, ores, coal, and oil—appears promising, the near-term prospects are for slow growth. Exports of manufactures will make the largest gains this year, as the Chinese continue to substitute exports of processed goods for raw materials wherever possible (see figure 3).

Over the past two years domestic supply shortages and weak foreign demand have hampered Chinese exports to the developed countries. Exports of agricultural commodities, petroleum, and other raw materials have stagnated or declined because of increasing demands in China and decreasing prices abroad. Petroleum exports dropped to $4.2 billion in 1983, reflecting price cuts of almost 15 percent. The volume 25X1
of crude oil exports, however, increased almost 2 percent to 300,000 barrels per day (14.8 million tons), 25X1
an indication that Beijing continues to give high priority to exports despite increased shortages at home. 25X1

Inadequate rail and port capacity continues to constrain coal exports. Nevertheless, this year the volume of exports should increase to nearly 7 million metric tons—1 percent of total output. Japanese, European, and US firms are actively negotiating joint development projects with the Chinese. A major agreement was signed earlier this year with a US firm concerning the development of China's potentially largest open pit mine—the Pingshuo Mine in Shanxi. 25X1
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Exports from the Chinese mines, 25X1
however, will not come onstream for two to three years. 25X1

The Chinese have attempted to increase export earnings from their manufactures by moving into higher-value-added lines. Part of the reason for this strategy has been the increase in volume quotas and other quantitative restrictions on imports from China in the 25X1
West, which force the Chinese to export better quality, higher priced goods than they otherwise would. But the Chinese are also trying to increase their gains from trade by moving into exports that reflect their comparative advantage in labor-intensive products. By branching out into industries that require large inputs of manual labor, they hope to absorb some of the large number of unemployed into the work force. Unemployment among the urban labor force of 114 million probably is much larger than the official unemployment figure of 2.6 percent reported at the end of June 1983. 25X1
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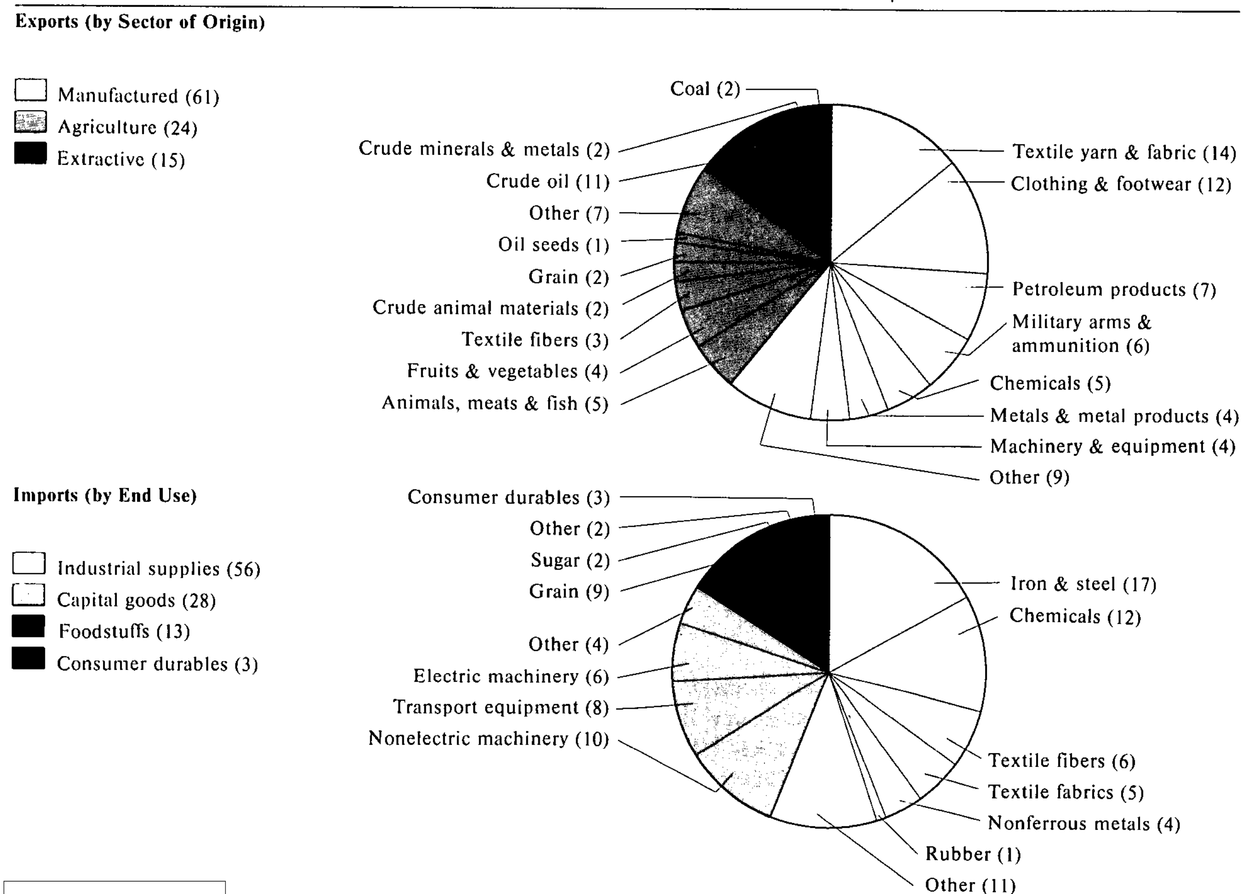
Figure 3
China's Commodity Composition of Trade, 1983

Percent



[redacted] 25X1

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To compensate for declining exports to the developed West, Beijing has tried to open up new markets in the Middle East, the Soviet Union, South Korea, and Latin America. In the Middle East, in each of the last two years, China has delivered over $1 billion in arms to Iraq [redacted] and Iran, although sales to the latter appear to have ended. [redacted] In Eastern Europe and the USSR the Chinese have found trade partners eager for cheap textiles and consumer goods that have been restricted in the West.

Trade with the USSR increased 110 percent in 1983 and is scheduled to double again this year. This trade is only one-seventh as large as Sino-US trade and, over the long term, its growth will depend on continued improvements in political relations. [redacted]

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Since 1980 the Chinese have sharply expanded contacts with South Korean businessmen. While Beijing is sensitive to P'yongyang's concerns over improvements in Sino–South Korean relations, the Chinese

Table 2
China's Top 10 Trade Partners, 1983

Million US $, f.o.b.

Japan	9,764
Hong Kong	8,341
United States	4,425
West Germany	1,743
Jordan	1,527
Canada	1,389
Singapore	1,001
Brazil	856
France	827
USSR	648

view South Korea as a large potential market for its coal. Two-way trade totaled more than $400 million last year. The recent cooling of relations over the release of six Chinese hijackers, however, could reduce trade.

Brazil catapulted into the ranks of China's top 10 trading partners last year as Chinese exports—primarily crude oil—soared to nearly $600 million (see table 2). Trade missions have exchanged several visits in the last few months, and trade this year probably will exceed $1 billion.

A Resumption of Foreign Purchases

Last year imports rose 10 percent to $18.4 billion, after bottoming out in 1982. In contrast to 1982, when foodstuffs—chiefly grain and sugar—were the only major category of imports that increased, last year China sharply stepped up imports of industrial supplies and capital goods. We expect imports to grow this year on the order of 25 to 30 percent. Capital goods will show the largest gains, and industrial supplies will show growth in selected areas, but agricultural imports will continue to decline.

Favorable weather has led to four consecutive years of bumper harvests, reducing the need for agricultural imports. Furthermore, the Chinese are reducing the area sown to food grains in order to increase the output of commercial crops such as cotton and oil seeds. These adjustments are having a major impact on China's agricultural trade. Last year, for example, China cut back substantially on cotton imports and began exporting for the first time. Within the next few years China probably will emerge as an important cotton exporter. This development could significantly hurt US exports, especially to major Far Eastern markets. 25X1

Grain imports dropped from 15.4 million tons in 1982 to 13.5 million last year, in part because of increasing supplies at home.[6] US sales fell from 8.5 million tons to 3.8 million last year—a loss of more than $700 million—as China shifted purchases to Argentina and Canada during the dispute over US restrictions on 25X1 textile imports from China. Shipments fell 2.2 million tons short of the 6-million-ton minimum required under the US-China long-term grain agreement.

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We believe three factors explain the fall in US shipments: lower import demand, the textile dispute, and the efforts of France and Argentina to move their 25X1 large stocks of wheat by price cutting. Lower import demand would have cut US exports by about 1 million tons, or $150 million, since this factor presumably would not have affected the US market share. But the US share of China's grain imports fell from 55 percent in 1982 to only 28 percent in 1983 as a result of the combined effects of price cutting and the textile 25X1 dispute. This lower share represented a loss of about $550 million, or 4.7 million tons. And the largest part 25X1 of this $550 million drop—roughly $300-400 million—is the result of the textile dispute, without which China probably would have bought at least the 6-million-ton minimum. 25X1

We project that total grain imports will decline to 12-13 million tons in 1984. For the first half of the year, imports from the United States totaled 2.5 million tons. The Chinese would have to make sizable purchases immediately in order to reach the minimum

[6] China's domestic crop reached a record 387 million tons—a 34-million-ton increase over 1982. 25X1
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required under the agreement. We think it is increasingly likely that China will use the recent change in US rules for determining the country of origin for textile imports,[7] when and if it is implemented, as a reason for retaliating with another grain embargo. Under these circumstances, we believe the Chinese will let the long-term grain agreement expire when it comes up for renewal at the end of this year.

Imports of most industrial supplies picked up substantially in 1983, reflecting increases in domestic economic activity and growing domestic shortages. Steel imports nearly doubled to 9.9 million metric tons as China surpassed the United States as Japan's number-one customer. Imports of copper, aluminum, nickel, and zinc also made impressive gains. Record imports of logs and plywood, two-thirds of which came from the United States, reflected the speedup in Chinese construction activities. Aside from its lumber sales, however, the United States was one of the few countries that did not benefit from China's increased purchases of industrial supplies, perhaps because of an exceptionally strong US dollar.

We expect that imports of industrial materials this year will remain at about last year's level, with some exceptions. Lumber, plastics, and fertilizer are growing strongly. Rubber imports are down, however, and cotton and synthetic textile fiber imports will continue to slump. Imports of US lumber may be vulnerable if there is another imbroglio over textiles. China probably could turn to the Soviets and Canadians to fill its needs.

Recovery of investment in China has resulted in a resurgence of capital equipment imports, which increased to $5.2 billion last year, up 36 percent over 1982. Transportation equipment especially had a banner year, and as a result US sales of aircraft and trucks increased. US exports of computers, telecommunications equipment, machine tools, medical electronic apparatus, and heavy construction equipment also grew. Associated with the jump in capital equipment purchases has been a Chinese push to obtain pure technology. In the past year the Chinese have purchased know-how in such diverse areas as tree cultivation, insecticide chemistry, water control, food preservation, coal excavating and gasification, building materials research, iron ore dressing, large-scale integrated circuits, cargo handling, birth control, disease treatment, environmental protection, and energy conservation.

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We expect China's capital equipment imports to climb 50 to 70 percent this year. Transport equipment purchases in particular have surged, boding well for the United States in such areas as jet aircraft, helicopters, locomotives, marine radar, and support vessels. Imports of mining and construction equipment, fueled by the offshore drilling activity, have also risen sharply. Imports of oil industry equipment, such as production platforms for the Bohai Bay and South China Sea, are increasingly being paid for by foreign joint-venture firms and thus do not represent a major drain on China's foreign exchange reserves.

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Similarly, imports of military equipment and weapons may increase, depending in large part on the willingness of the United States and other Western countries to sell. Although China's long-term commitment to military self-sufficiency remains firm, in the short run the Chinese are willing to buy some weapons systems outright and are negotiating such deals with both European and US companies.

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Foreign Investment

Until last year Beijing's progress in attracting foreign investment had been slow, in part because of the uncertainty of Chinese leaders and planners as to the extent of the incentives that should be offered to foreign companies. Other obstacles have been China's inexperience, lack of credibility with foreign businessmen, inadequate infrastructure, problems with labor productivity and wages, and the lack of detailed regulations on taxes and remittances of profits.

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[7] According to the new rules, textile products that are shipped among several countries during manufacture would be charged proportionately to the quotas of the country where the processing is done. Past rules charged products to the quota of the country that processed them last. The new system has caused great concern among textile exporting countries because it is expected to stifle legitimate trade mechanisms. China expects to lose 50,000 to 100,000 jobs and more than $300 million in revenues from the change.

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Last year, however, Beijing made a range of concessions to gain more foreign participation in modernizing the economy. Scores of new laws have been released to attract or protect the foreign investor. In September, China issued regulations to clarify its 1979 Joint-Venture Law. The rules offered longer tax holidays, increased opportunities to sell the output of joint ventures in the domestic Chinese market, and provided more decisionmaking autonomy for ventures. Early this year China introduced new tax rules that exempt joint ventures from import duties and abolish certain industrial taxes on ventures that import advanced machinery and technology. Last April the opening of 14 additional port cities and Hainan Island to foreign investment gave entrepreneurs many of the advantages of the Special Economic Zones. In addition to ratifying this decision, the National People's Congress endorsed laws clarifying the status of totally foreign-owned companies in China. [redacted]

At the end of 1983 there were 188 "equity" and 1,047 "contractual" joint ventures in China.[8] In addition there were 18 cooperative projects for offshore oil prospecting and exploitation. At the end of 1983 total paid-in foreign investment on these three forms of direct investment amounted to approximately $1.5 billion. Of that total about $380 million is in the four Special Economic Zones, with the bulk in Shenzhen, on the Hong Kong border. If licensing agreements, processing and compensation trade, and wholly owned foreign subsidiaries are included in the totals, in accord with Chinese practice, total paid-in foreign investment amounted to $2.3 billion through the end of December 1983 (see table 3). [redacted] 25X1

Table 3
Direct Foreign Investment in China [a]

Million US $

	Pledged (Yearend)			Paid-in (Yearend)	
	1981	1982	1983	1982	1983
Total	**2,846**	**4,958**	**6,600**	**1,769**	**2,345**
Equity joint ventures	88	141	340	103	166
Contractual joint ventures	1,800	2,726	2,900	530	730
Joint oil exploration	498	999	2,000	486	651
Compensation trade	460	725	930	413	542
Other businesses [b]		367	420	237	254

[a] Chinese data, which include licensing, processing, and compensation agreements that would not necessarily be used in Western definitions of foreign investment. 25X1
[b] Including wholly owned foreign enterprises and licensing agreements.

[redacted] 25X1

As of November 1983, American investors had spent $406 million on 23 joint projects in China. There were 16 equity joint ventures involving $91 million, one $10 million cooperative management project, and eight agreements for joint exploitation of offshore oil worth $305 million. The three largest nonoil Sino-US joint ventures are the Great Wall Hotel with US participation of $35 million, the Jianguo Hotel with US assets of $11 million, and American Motors Beijing Jeep Corporation with $16 million in US assets. [redacted] 25X1

China's competitive offshore leasing program got under way last year and now boasts 23 exploration and development contracts with 31 foreign oil companies, including 12 US firms. Drilling will begin this year on most of the blocks, which are located in the

[8] From a Western viewpoint, both forms of joint ventures, as well as joint oil exploration agreements and wholly owned foreign subsidiaries, are considered direct foreign investment. In our balance-of-payments estimates, other forms of business arrangements, such as licensing, processing, and compensation trade agreements, are not treated as foreign investment since no foreign claims on real assets located in China exist. The Chinese, however, use the term "foreign investment" loosely to refer to all forms of foreign participation, even loans to Chinese enterprises. The Chinese appear to use the term "cooperative production agreement" synonymously with "contractual joint venture." From a Chinese legal viewpoint, there are three chief distinctions between contractual and equity joint ventures:

(a) Equity joint ventures fall under the joint-venture tax law (a flat 33-percent tax), whereas contractual ventures are taxed on a graduated basis under the foreign enterprise income tax.

(b) Equity joint ventures share profits in proportion to equity participation, whereas contractual joint ventures share profits according to a ratio agreed to in the contract.

(c) Equity joint ventures form new legal entities with their own boards of directors, whereas contractual joint ventures are managed directly by their parent corporations. [redacted] 25X1

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Yellow and South China Seas. 25X1

Exploration continued last year in offshore areas previously leased to Japanese, French, and US firms. The Japanese have had success exploring in the Bohai and will soon begin developing at least one field. Atlantic Richfield found a commercially viable natural gas field in its concession south of Hainan, but the discovery was marred by the loss of the drill ship and its 80-member American-Chinese crew in an October typhoon. The Chinese have asked Atlantic Richfield to lead a multibillion-dollar joint venture to use the gas from this field to produce fertilizer on Hainan Island.[9]

The Chinese have also signed preliminary agreements with foreign investors for the Guangdong nuclear power plant and for development of the Pingshuo and Jungar open pit coal mines. They are currently arranging financing for these projects and work could begin by early next year.

Despite the obstacles to foreign investment posed by differences in economic environments and investment philosophies between China and the West, China's efforts to attract foreign investment have been relatively successful. Foreign investment in China at the end of 1983 was on a par with that in South Korea, just slightly below that of Taiwan, and about one-quarter the level of the other Asian NICs (newly industrialized countries)—Hong Kong and Singapore—and Indonesia (see table 4). By midyear 1984, however, foreign investment in China—led by exploration for offshore oil—probably surpassed that in South Korea or Taiwan. 25X1

Foreign Debt

The Chinese have used very little of the $27 billion in commercial and government-supported credit lines they arranged in 1979 (see table 5). Fiscal conservatism and cutbacks in capital expenditures, rather than the previous ideological aversion to foreign debt, have left little need for these loans. 25X1

[9] If approved, the fertilizer plant would be the largest in the world. Atlantic Richfield is attempting to enlist other Western firms to help finance and build the project.

Table 4 *Billion US $* 25X1
Paid-in Direct Foreign Investment in Selected East Asian Countries, Yearend 1983

China	1.5
South Korea	1.5
Taiwan [a]	1.5-2.0
Indonesia [b]	5.1
Hong Kong [c]	6.0-8.0
Singapore [c]	5.0-7.0

[a] Estimated from data on commitments.
[b] Excluding offshore oil.
[c] Estimated from official data on investment in the manufacturing sector and from other indicators. 25X1

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China's current outstanding debt of $5.7 billion is a mixture of commercial and official loans with a wide range of maturities. For the past three years commercial borrowing has been cut back sharply, and it now accounts for less than one-quarter of the total debt. China is seeking only concessionary loans and will avoid incurring commercial debt for all but short-term trade financing 25X1

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Table 5
China's External Debt by Type of Credit

Million US $

	1978	1979	1980	1981	1982	1983
Total stock of outstanding debt (at end of year)	**2,488**	**5,075**	**5,975**	**5,728**	**5,874**	**5,700**
Bonds	0	0	0	0	40	40
International organizations	0	0	0	0	3	NA
Government-to-government loans	0	0	11	31	367	500
Energy loans from Japan Ex-Im Bank	0	0	435	895	1,109	1,309
Buyer credits (guaranteed by foreign governments)	0	36	142	340	638	1,200
Supplier credits (long term only)	1,736	1,723	1,582	1,138	1,504	NA
Borrowings from commercial banks	752	3,316	3,805	2,440	1,376	828
Borrowings from IMF						
First credit tranche	0	0	0	524	496	0
Trust fund	0	0	0	360	341	32
Total debt servicing (during year) [a]	**620**	**859**	**1,493**	**2,415**	**2,388**	NA
Principal	405	509	881	1,594 [b]	1,747 [b]	NA
Interest	215	350	612	821	641	NA
As a percentage of:						
Exports	6.1	6.4	7.9	11.2	10.2	
Current account earnings [c]	5.3	5.4	6.8	9.5	8.6	

[a] Includes interest charges but excludes principal on short-term bank borrowing.
[b] During 1981 and 1982 China prepaid $800 million and $1,100 million in loans, respectively, which accounts for the abnormally large increase in debt servicing. Excluding these prepayments, China's ratio of debt service to exports in these years amounted to 8.6 and 5.5 percent, respectively.
[c] Data include exports, total earnings, and total credits.

[redacted] 25X1

Earlier this year Tokyo also agreed to extend another $2.6 billion in Japan Export-Import Bank resource development loans to cover oil and coal development projects. The new loans will carry interest rates of 7.1 to 7.3 percent. This compares with the 6.25-percent rate on the $2 billion line-of-credit that the Export-Import Bank provided in 1979. [redacted]

[redacted]

The Chinese have also obtained commitments for over $1.9 billion from the World Bank. The loans will cover 18 projects, including four for energy, two for communications development, four for agriculture, and the rest for education and medicine. Loans for energy account for 27 percent of the total; those for communications, 18 percent; and those for educational projects, 22 percent. Of the total, the International Bank for Reconstruction and Development has contributed about $1.2 billion and the IDA (the International Development Association) has contributed $734 million. Only a small fraction of the loans have been drawn. While at first glance these loans might appear to crowd out commercial lending, this probably is not the case, since most of them are for infrastructural projects that do not provide high or immediate returns and thus would not attract commercial lenders. [redacted]

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Appendix

China's Balance of Payments [a]

Million US $

	1978	1979	1980	1981	1982	1983 [b]
Current account	**24**	**−1,113**	**−999**	**3,257**	**7,676**	**5,354**
Trade balance [c]	−161	−906	−305	3,547	6,800	5,665
Exports, f.o.b.	10,170	13,458	18,875	21,496	23,459	24,019
Imports, f.o.b.	−10,331	−14,364	−19,180	−17,949	−16,660	−18,354
Services, net	−343	−833	−1,264	−862	405	−700
Total earnings	1,028	1,736	2,472	3,205	3,618	3,900
Freight and insurance [d]	245	416	680	1,103	986	1,000
Passenger services	13	33	106	113	140	161
Port dues, ship chandlering	180	316	385	422	389	NA
Travel receipts	241	413	511	672	703	780
Reinvested earnings from direct investment abroad [e]	32	43	63	75	105	NA
Bank interest and charges	200	305	512	697	998	1,270
Labor income and other services	117	210	215	123	297	NA
Total expenditures	−1,371	−2,569	−3,736	−4,067	−3,213	−4,600
Freight and insurance [d]	−623	−938	−1,253	−1,357	−1,100	−1,430
Passenger services and travel abroad [f]	−6	−12	−35	−69	−66	NA
Port dues, ship chandlering	−227	−376	−566	−710	−612	NA
Reinvested earnings from direct investment in China [g]	0	0	−9	−28	−38	
Bank interest and charges	−215	−350	−612	−821	−641	−500
Labor expenses, other services, and transfers	−96	−316	−272	−376	−544	
Technology payments [h]	−204	−577	−989	−706	−212	−1,200
Unrequited transfers, net	528	626	570	572	471	389
Total credits	597	656	689	640	659	589
Remittances from overseas Chinese	597	656	668	484	544	520
Aid from international organizations	0	0	21	156	115	69
Total debits	−69	−30	−119	−68	−188	−200
Remittances of foreigners, plant cancellation fees	0	0	−28	−20	−14	NA
Chinese foreign aid	−69	−30	−91	−48	−174	NA

China's Balance of Payments [a] (continued)

Million US $

	1978	1979	1980	1981	1982	1983 [b]
Capital account, excluding reserves	**−1,027**	**2,265**	**1,841**	**−876**	**−364**	**−1,000**
Long-term capital, net [i]	−786	711	1,765	83	−322	−966
Direct investment abroad	−57	−68	−98	−93	−430	−750
Equity capital	−25	−25	−35	−18	−325	NA
Reinvestment of earnings abroad	−32	−43	−63	−75	−105	NA
Direct investment in China	0	0	101	321	460	384
Equity capital	0	0	92	283	384	280
Reinvestment of earnings in China	0	0	9	38	76	104
Portfolio investment in public-sector bonds [j]	0	0	0	−9	20	−300
Foreign bond purchases [j]	0	0	0	−9	−20	−300
Chinese bond flotations	0	0	0	0	40	NA
Drawings on loans received	506	1,862	2,928	1,784	1,894	1,500
Government-to-government loans [k]	0	0	11	19	333	NA
Energy loans from Japan Ex-Im Bank	0	0	435	460	225	200
Buyer credits [l]	0	36	106	207	335	NA
Supplier credits [l m]	506	496	539	177	886	NA
Processing and compensation arrangements [n]	0	0	294	85	106	NA
BOC borrowings from foreign banks	NA [o]	1,330	349	44	0	0
Non-BOC borrowings from foreign banks [p]	0	0	195	125	55	NA
Nonresident deposits with BOC, net [q]	0	0	999	288	−46	NA
IMF Trust Fund loan	0	0	0	379	0	0
Repayment of loans received	−405	−539	−948	−1,670	−1,871	−1,800
Buyer credits	0	0	0	−9	−42	NA
Supplier credits	−405	−509	−680	−621	−519	NA
Processing and compensation arrangements	0	0	−57	−66	−59	NA
BOC borrowings from foreign banks	NA [o]	NA [o]	−201	−844	−1,089	NA
Non-BOC borrowings from foreign banks	0	0	0	−120	−97	NA
Settlement of blocked US assets, other transfers	0	−30	−10	−10	−65	NA
Drawings on loans extended [r]	−900	−613	−253	−284	−413	NA
Repayment of loans extended [r]	70	69	35	42	18	NA
Short-term capital, net [i]	−241	1,554	76	−959	−42	NA
Supplier credits received (drawings net of repayments)	−35	447	174	121	177	NA
Supplier credits extended (drawings net of repayments)	NA [o]	NA [o]	−156	−662	−318	NA
Bilateral payment agreements assets (net change)	−379	−127	−80	110	56	−87
Short-term bank borrowings, net	173	1,234	138	−528	43	NA

China's Balance of Payments [a] (continued) *Million US $*

	1978	1979	1980	1981	1982	1983 [b]
Reserves [s]	**748**	**−603**	**−226**	**−1,782**	**−6,294**	**−3,983**
Monetary gold	−40	−6	19	55	25	27
Total change in holdings	NA [o]	NA [o]	NA [o]	NA [o]	NA [o]	NA [o]
Counterpart to demonetization of gold	0	0	0	−5	0	0
Counterpart to valuation changes	−40	−6	19	60	25	27
Special drawing rights	0	0	54	−41	61	−121
Total change in holdings	0	0	−92	−183	61	−121
Counterpart to allocation of SDRs	0	0	146	142	0	0
Reserve position in IMF	0	0	−191	191	0	−176
Use of IMF credit	0	0	0	524	−28	−496
Total	0	0	0	524	0	−485
Counterpart to valuation changes	0	0	0	0	−28	−11
Foreign exchange assets	788	−597	−108	−2,511	−6,352	−3,217
Net errors and omissions	**255**	**−549**	**−616**	**−584**	**−1,018**	**−371**

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